MONEYBALL FOR ADVISORS

Use **data** and **analytics** to drive future **outperformance**

PriceMetrix®

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INTRODUCTION

The application of statistics to professional sport was made famous by the book *Moneyball: The Art of Winning an Unfair Game* by Michael Lewis. The book was subsequently made into a movie, with Brad Pitt playing the role of Oakland A's general manager Billy Beane. A central question of both the book and the film was: how could a small-market, small-budget baseball team like the Oakland A's compete against teams from larger markets that had the resources to pay top dollar for superstar players?

The answer, in brief, was to challenge conventional wisdom and the intuition of baseball experts about how to predict future success and build a winning baseball team. The Oakland A's conducted a data and analytics-driven exercise. Using statistical analysis, the A's identified player statistics that were most predictive of winning baseball games (and a winning team was one that baseball fans paid to see). Some of the metrics that baseball insiders valued – such as runs batted in and bases stolen – were naturally priced high in the market for baseball talent. They were also mediocre predictors of games won. At the same time, other metrics – such as on-base percentage and slugging percentage – were more predictive of winning games, yet were underpriced. By targeting overlooked players who scored well on underpriced metrics, the Oakland A's were able to build a winning baseball team less expensively.

Does the Moneyball revolution in baseball have anything to teach retail wealth management? To be sure, there are a number of high-level similarities between the two. Highly-ranked talent has proven particularly mobile, moving from team to team (or firm to firm) as incentives dictate. As a consequence, recruiting top talent has become an increasingly expensive proposition: in the case of the retail wealth management industry, it is not uncommon for high-performing advisors to be offered a multiple of two times their annual production to join a new firm. An entire cadre of recruiters that focus exclusively on financial advisors exists, and news of high-profile advisors moving from one firm to another has become a common occurrence. A recent Reuters report noted that even in an era of tight budgets, "brokerages are often willing to pay top dollar for advisers with significant client assets."[1]

Like professional baseball, however, the payoff for the hiring firm (or signing team) remains uncertain. With incentives based upon some combination of past performance and future performance, the payoff is difficult to foresee; and with prices getting higher and higher, selecting the right talent is more important than ever. A brokerage industry veteran recently observed that the economics of recruiting advisors "has gotten to the point where it's very difficult to continue to make money." But still, "you have to do it from a competitive standpoint." Some hires, however, turn out to be based on a "bad assumption" about future production, which is obviously detrimental to the business.[2] The corollary for recruiting is to direct their recruiting resources and cash to advisors with the greatest prospects for outperformance, and for advisors to concentrate their time, a scarce resource, on those factors that drive outperformance.

[1] Ashley Lau, "Hard Times at Brokerages Spell Good Times for Headhunters," Reuters, October 16, 2012.
[2] Tom Stabile, "Wirehouses Will Take Fight to Indies: Exec." Fundfire, October 23, 2012.

Several PriceMetrix clients wanted to know if statistical analyses could be deployed, much as they are in baseball, to help them ensure – rather than simply assume – that they are recruiting the right candidates and allocating resources to those advisors with the greatest potential.

Research undertaken by the PriceMetrix *Insights Lab* confirmed that analytics can indeed be used to gain an informed advantage in recruiting and development.

When it comes to recruiting financial advisors, a hire that is seen as a "success" has certain requisite qualities, including the absence of compliance issues and a healthy margin. In this paper, our focus is on production (and growth in production over time) as a hallmark of a successful hire. The answers we provide can assist recruiters in identifying those candidates most likely to add to the future growth of the firm. It can also assist managers and advisors by highlighting those attributes most predictive of future growth in an advisor's book. These insights can help advisors and managers take action now to best achieve breakaway growth.

This report is made possible by PriceMetrix aggregated retail brokerage data representing 6 million investors, 500 million transactions, 1.6 million fee-based accounts, 7 million transactional accounts, and over $3.5 trillion in investment assets. PriceMetrix combines its patented process for collecting and classifying data with proprietary measures of revenue, assets, and households to create the most insightful and granular retail wealth management database available today.

All results are reported as of December, 2011. PriceMetrix found no significant difference between the U.S. and Canadian markets, so all results presented in this paper are for the combined North American market.

DATA AND METHODOLOGY

The model we developed was designed to predict <u>future</u> revenue as a function of advisor and book metrics from a benchmark time period. To do this, potential predictors were drawn from end-of-year 2006 figures for advisors in the PriceMetrix database with 5 to 20 years experience (this range was selected as being representative of the majority of advisors changing firms). The outcome being predicted was the twelve-month total revenue for 2011, five years beyond our baseline metrics.[3]

Obviously, forecasted production is not a function of a single factor. Many different factors may potentially have an impact – including advisor production in a baseline period, demographic characteristics and information on advisor client mix, among others. We examined dozens of attributes of a book and characteristics of advisors, in search of those that most powerfully predicted future production – many more than appear in this paper. Not all proved to be predictive, and so do not feature in the final model.[4] The end result is a robust, highly predictive model, comprised of a small number of predictors, that offers clear guidance on what factors determine future production. Managers can use this predictive model to help select preferred candidates in the recruitment process, or to coach their existing advisors to perform better. Advisors can use it to groom their books in order to ensure they have the highest likelihood of growing and succeeding.

PRODUCTION AS A MEANS TO PREDICT FUTURE PRODUCTION

Not surprisingly, advisor production in a baseline period is highly predictive of production in five years' time. This is what we would expect, since the norm when recruiting advisors is to offer incentives that are based in part on current levels of production.

At the same time, not all types of production – transactional, trailer and fee – are created equal. It turns out that baseline-period fee revenue is more predictive of future revenue than either transactional or trailer revenue. This is again, what we would expect given that fee revenue is considered more resilient and stable than either transactional or trailer revenue.

After controlling for the effects of other predictors, the link between benchmark-period production (2006) and production five years into the future (2011) works in the following way. First, assume an advisor with average production levels in each of transactional, trailer and fee business in 2006. Next, we systematically vary the amount of fee-based revenue. Now, assume two advisors with average scores on all other metrics but with different levels of fee revenue in 2006. One is below average with $100,000 in fee revenue in 2006; the other is an outperformer with $700,000 in fee revenue in 2006. The predicted indexed performance[5] of the first advisor is -12; for the second advisor, it is 62 (see Figure 1).

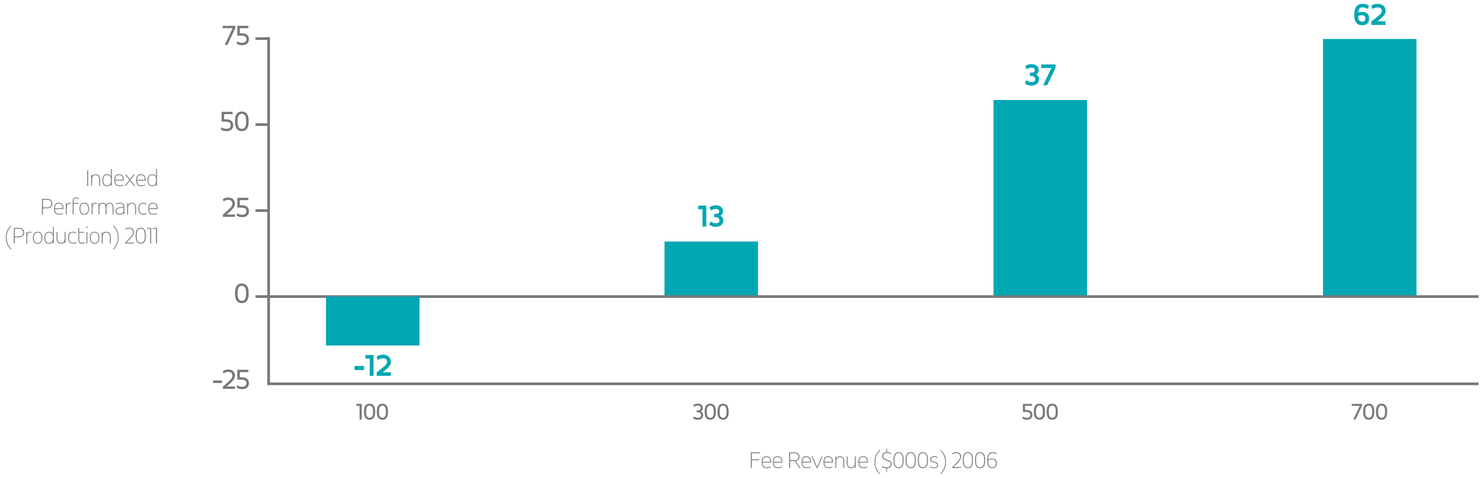
[3] Revenue data are client account revenue only; revenue from pro accounts and net interest margin were excluded.

[4] An insightful, actionable forecasting model should also identify how much of future production can be uniquely attributed to each of the individual predictors. All of these considerations point in the direction of using multivariate statistical tools to examine the unique effects of predictors while controlling for – meaning parsing out, statistically – the effects of other predictors.

[5] Indexed performance refers to scaling the model-adjusted mean total revenue for 2011 to be equal to zero. Scores above zero therefore represent above-average performance; scores below zero represent below-average performance.

What this points to is the importance of examining the different sources of revenue in an advisor's book when evaluating prospects. Those with more production coming from fee accounts (as opposed to transactional and trailer revenue) are expected to be bigger future producers.

Figure 1 - Fee Revenue (2006) and Production (2011)



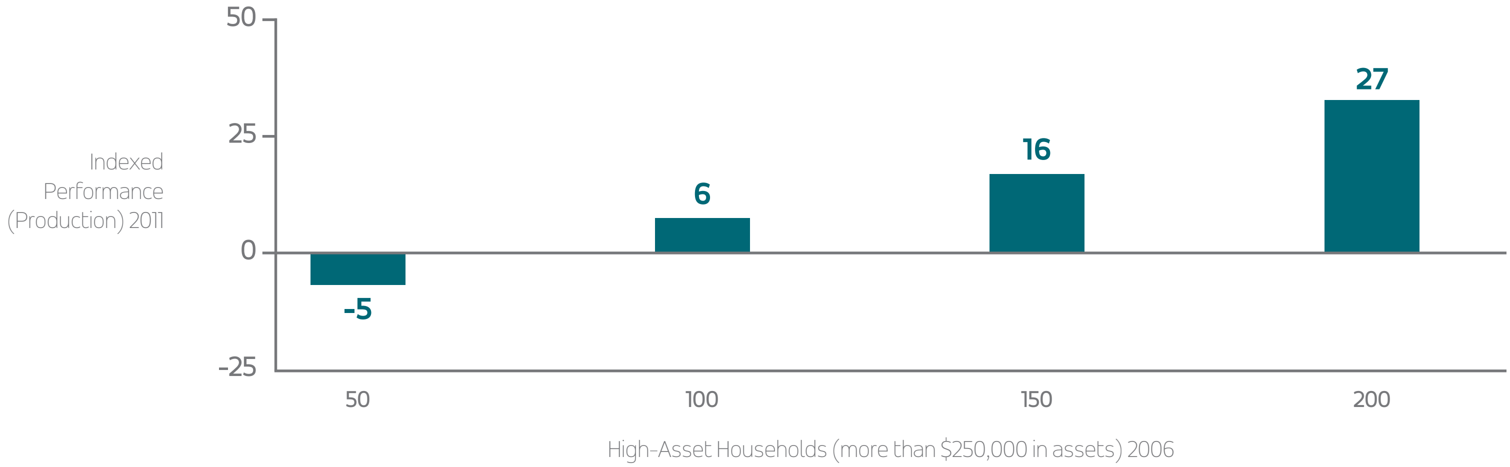
We can conclude that, while current production can indeed help predict future production, not all production is created equal.

IN RETAIL WEALTH MANAGEMENT, SIZE DOES MATTER

One continuing challenge faced by financial advisors is to acquire (and then retain) new clients – preferably with significant assets. Most advisors believe that the greater the number of high-asset households in a book, the better. Our predictive model confirms this belief.

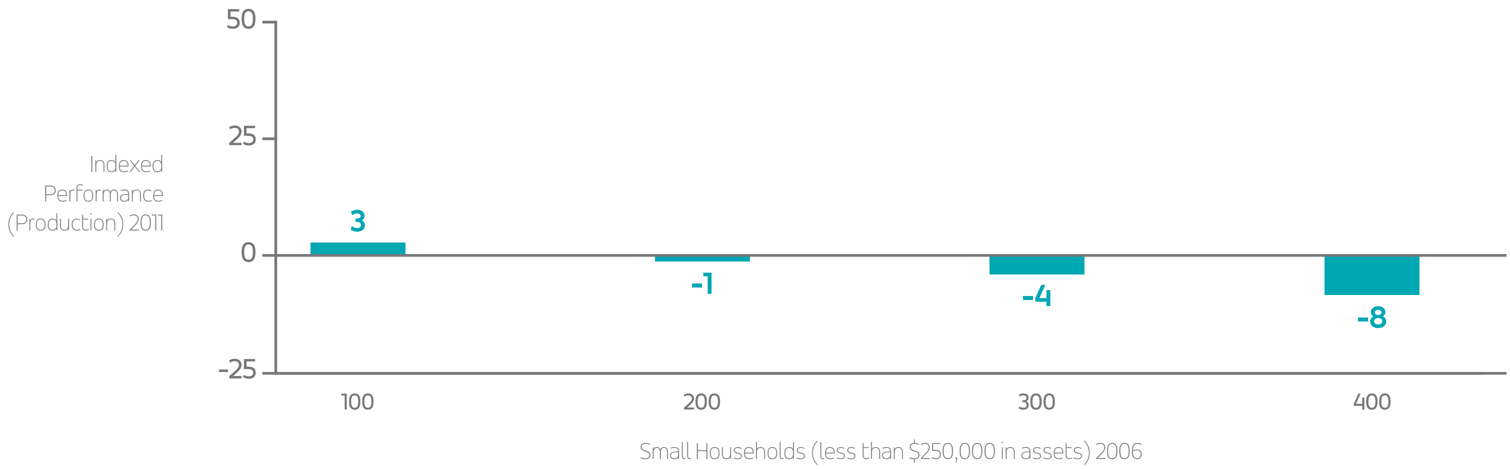
After controlling for other predictors, we discovered that for every high-asset household (defined as those with $250,000 or more in investable assets) in an advisor's book, predicted future annual revenue is expected to increase by $1,650. To illustrate this, consider again two advisors with average scores on all other metrics but who have different numbers of high-asset households in their respective books – one with 50 (below average), and the other with 200 (an outperformer). The advisor with 50 high-asset households is expected to have indexed performance of -5 in 2011; the advisor with 200 high-asset households is expected to have indexed performance of 27 (see Figure 2).

Figure 2 - High Asset Households (2006) and Production (2011)



Our analysis also found that the number of small households (defined as those with less than $250,000 in assets) had a significant effect on future production – a negative one. Advisors actually pay a penalty in terms of decreased future revenue for the small households they keep in their books. For every small household in an advisor's book, predicted future revenue is expected to decrease by $270 per small household, per year.[6] For the average advisor with 173 small accounts in his or her book, this works out to a total small household penalty of more than $46,000 annually. Controlling for other predictors, an average advisor with 100 small households is expected to have indexed performance of 3 in 2011; an advisor with 400 small households is expected to have indexed performance of -8 (see Figure 3).

Figure 3 – Small Households (2006) and Production (2011)



These results highlight the importance of client mix in an advisor's book. Large households contribute to increased future production. On the other hand, the effect of keeping small households in one's book is malignant, as previous PriceMetrix research on small households has shown.[7] Advisors actually pay a small-household penalty.

[6] This reflects production that otherwise would be expected to have been realized if that small household had not been in the book.
[7] PriceMetrix, "Small Household Metrics," Insight, June 2010.

DEPTH OF RELATIONSHIPS MATTERS TOO

Marketing research experts have long known that the depth of client relationships and client "share of wallet" are strongly linked to increased client retention and profitability. The results of our analysis align with these expectations: advisors with deeper client relationships (measured using a number of metrics) are predicted to have higher future production.

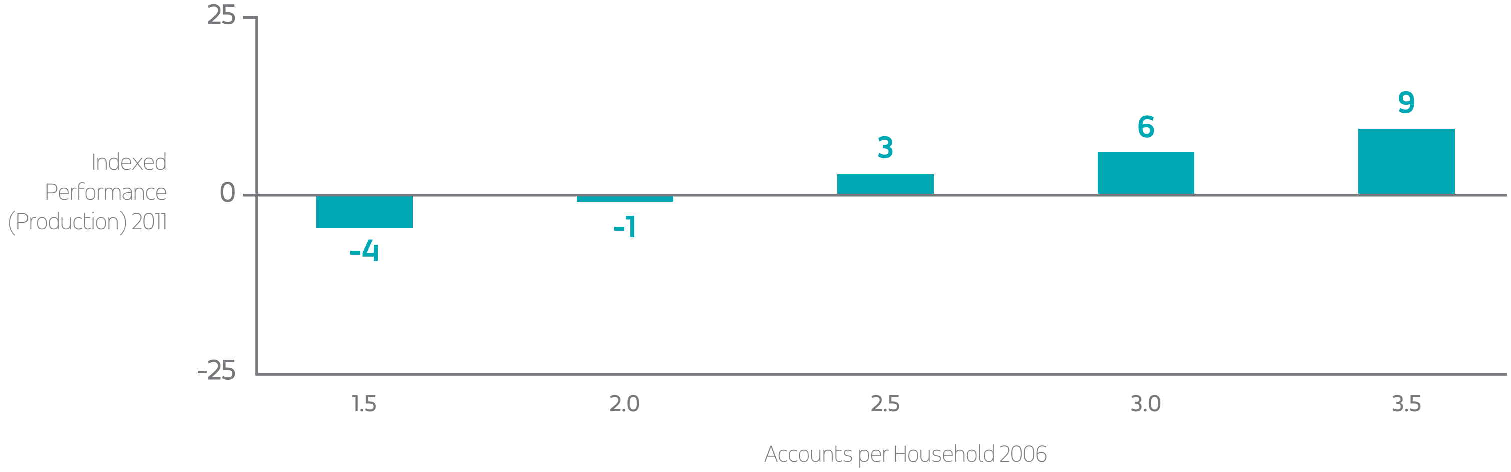
One good measure of the depth of client relationships is the number of retirement (IRA/401(k)/RRSP) accounts in an advisor's book. Previous PriceMetrix research has highlighted the contribution that retirement accounts can make to an advisor's book[8]. Our analysis has also revealed that the number of retirement accounts in a book is a predictor of future production. Indeed, after controlling for other predictors, each retirement account increases expected annual future production by $510. To draw this out, consider once more the case of two advisors with average scores on all other metrics but who have different numbers of retirement accounts in their books. An advisor with 50 retirement accounts (which is below average) is expected to have indexed performance of -5 in 2011. An advisor with 350 retirement accounts (an outperformer on this metric) is expected to have indexed performance of 15 (see Figure 4).

Figure 4 – Retirement Accounts (2006) and Production (2011)

Another simple measure of the depth of an advisor's client relationships is average accounts per household (simply the ratio of accounts to households in an advisor's book). Higher accounts per household imply deeper client relationships and a higher "share of investable assets" on average in a book. Accounts per household also prove to be predictive of future production. Controlling for other predictors, an advisor with a below-average accounts per household score of 1.5 is expected to have indexed performance of -4 in 2011. An advisor with especially deep client relationships and an accounts per household score of 3.5 is expected to have indexed performance of 9 (see Figure 5).

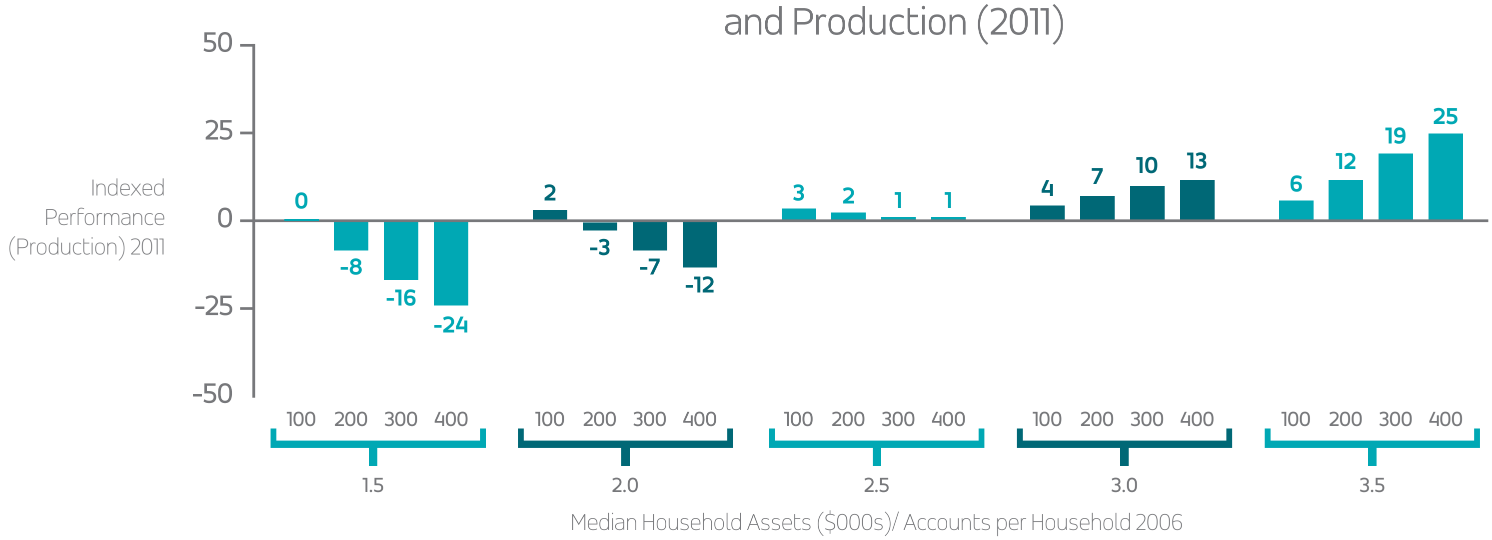
[8] PriceMetrix, "IRA & 401(k) Accounts: Good for your clients, good for you," Flash of Insight, February 2012.

Figure 5 – Accounts per Household (2006) and Production (2011)



Another key finding from our analysis is the conditional relationship between an advisor's median household size and the depth of client relationships. The common wisdom that it is good to have a book with a high median household size is actually contingent: high median household size is a positive predictor of future production only when accounts per household is also high. When accounts per household is low – implying rather shallow client relationships – high median household size is actually a negative predictor of future production (see Figure 6).

Figure 6 – Median Household Assets by Accounts per Household (2006) and Production (2011)



This analysis serves to highlight some of the important but often overlooked predictors of future revenue – namely those that capture the depth of an advisor's client relationships. It also highlights the risk inherent in a book – not in terms of the risk associated with securities held, but in terms of the durability (or lack thereof) of an advisor's relationships with her or his clients. It is the risk of customer churn.

A book with few retirement accounts and low accounts per household, all other things being equal, actually contains a higher element of risk than one with a large number of retirement accounts and a high number of accounts per household. It also provides direction to advisors: households with significant assets are attractive, but the medium to long-term benefit (in terms of production) is only realized if one can capture a high proportion of that household's share of investable assets.

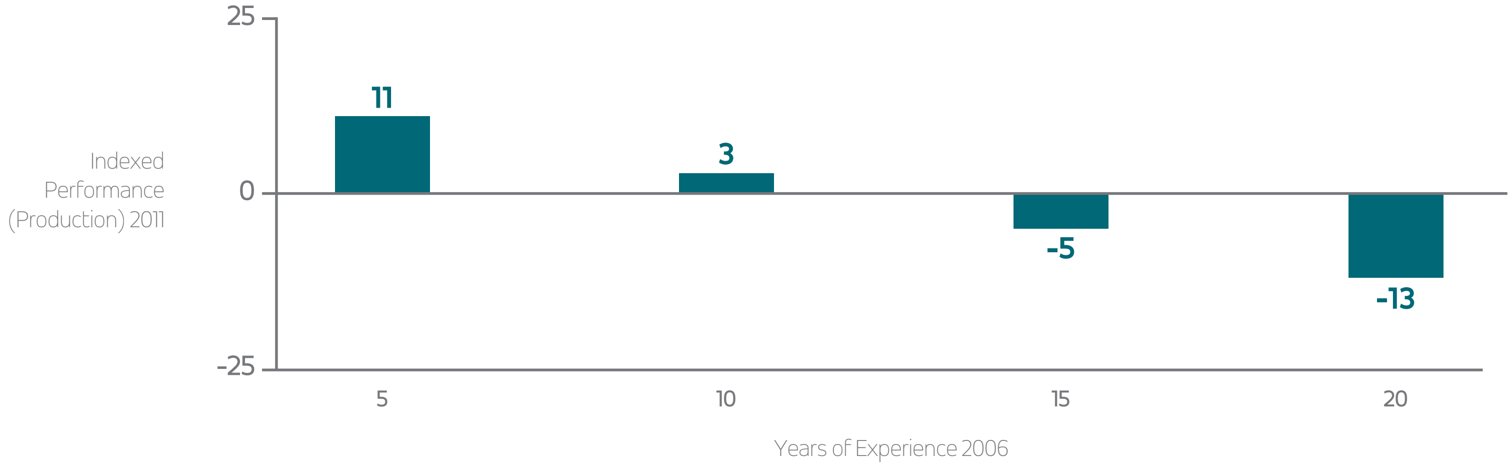
THE BENEFIT OF INEXPERIENCE

Common wisdom might suggest that a more experienced advisor would be more productive, and therefore a more attractive prospect for a hiring firm. However, our analysis showed that this is not the case. In the first instance, the data showed no clear relationship between experience and future production. Before controlling for any other predictors, experience had a negligible effect on predicted future production. Below-average producers, average producers and outperformers are found in roughly equal numbers at all levels of experience.

More interesting, though, is what the data revealed when the relationship between experience and future production was tested while controlling for the effects of other predictors. When other factors are included in the model, the effect of experience on future production is negative. For every year of experience, future production is predicted to decrease by $12,700. To illustrate, consider two advisors who are equal in all other respects – for example, average producers in a benchmark period, average number of large and small households, average levels of depth of client relationships, etc. In this scenario, the advisor with less experience has greater future potential for increased production.

Specifically, an advisor with 5 years of experience is expected to have indexed performance of 11 in 2011.
An advisor with 20 years of experience is expected to have indexed performance of -13 (see Figure 7).

Figure 7 – Years of Experience (2006) and Production (2011)



Simply put, an advisor who becomes a top producer after five years is a more attractive prospect than an advisor who reaches the same level of production after 20: the advisor with five years experience is on a higher growth trajectory.

CONCLUSION: THE ART OF WINNING IN RETAIL WEALTH MANAGEMENT

What should recruiters pay for, managers coach to, and advisors do to maximize outperformance?

Our research has identified the characteristics of a book that most accurately predict future production.

- Maximum fee revenue
- A high number of households with greater than $250,000 in assets
- A low number of households with less than $250,000 in assets, and a willingness to exit or transfer them
- Deep client relationships, as measured by a large number of retirement accounts and multiple account households
- Experience - all other things being equal, less experience means greater potential in the future

Recruiters can ask prospects probing, specific questions to reduce the uncertainty around expected future performance of new hires. Firms can improve their return on recruiting spend, by identifying 'undervalued assets'.

Managers can use this research in the evaluation of their current advisors, in order to improve the trajectory of future overall performance:

- Start by screening all the existing advisors in your sales force.
- Identify the future outperformers and hug them.
- Coach to areas of weakness with likely underperformers.

Advisors themselves can understand the factors that have the biggest influence on their future performance. While advisors obviously can't turn back the clock on length of service, other factors – such as fee-based revenue, client mix and depth of client relationships – are within their control.

As an advisor, what should you do to ensure you are best positioned for future growth?

- Acquire ONLY households with greater than $250,000 in assets
- Consider exiting or transferring to a different service channel, those households with less than $250,000 in assets
- Establish a plan to cross sell your households, starting with retirement accounts
- Focus your new product sales energies on fee and managed business

Undoubtedly, there will be some advisors with an orientation to transactional books, small households and low wallet share penetration that are able to outperform. There are always exceptions. However, the facts show that the odds are, alas, against them. Those that play the odds will more assuredly outperform.

If you'd like to understand your firm's "capacity" for future growth, please contact PriceMetrix. Our Advisory Team can help you understand how your firm's current advisor base will grow, how that growth will compare to your market peers, and how the growth breaks down, advisor by advisor.

For assistance with understanding the opportunities your firm, branch, and/or book of business represents, or to provide your feedback on this issue of *Insights*, please contact Patrick Kennedy, Vice President, Product and Client Services at +1 (416) 955-1728 or patrick.kennedy@pricemetrix.com.

The analysis delivered in this edition of insights is made possible by our aggregated market data and is the result of a collaborative effort by Patrick Kennedy, Vice President, Product and Client Services and Tim Gravelle, Principal Scientist & Director, Insights Lab

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